In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1645

COY L. WEAVER and HELEN F. WEAVER, PETITIONERS

v.

RICHARD M. HUTSON, II., TRUSTEE OF LANDMARK INNS OF DURHAM, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION [1]

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 34a) is not yet officially reported. There is no opinion of the district court (Pet. App. 32a-33a); the

[1] The Securities and Exchange Commission has been participating in this reorganization proceeding in the district court as a party pursuant to Section 208 of Chapter X of the Bankruptcy Act, 11 U.S.C. 608, since shortly after the commencement of the proceeding in 1969, and has taken positions in the district court and in the court of appeals similar to those expressed in this brief. As in *Protective Committee* v. *Anderson*, 390 U.S. 414, 420, n. 3, and *Caplin* v. *Marine Midland Grace Trust Co.*, No. 70-220, decided May 22, 1972, the Commission is "an unnamed respondent before this Court." See Rule 21(4) of the Rules of this Court.

"Findings of Fact, Conclusions of Law, and Order" of the Referee in Bankruptcy (Pet. App. 1a) are not reported.

JURISDICTION

The judgment of the court of appeals was entered on February 28, 1972 (Pet. App. 34a), and a petition for rehearing (Pet. App. 40a) was denied on March 31, 1972 (Pet. App. 46a). The petition for a writ of certiorari was filed on June 19, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1). See also 11 U.S.C. 47(c).

QUESTION PRESENTED

Whether, in the circumstances of this reorganization proceeding under Chapter X of the Bankruptcy Act, the referee in bankruptcy properly refused to enforce a forfeiture provision in a lease covering land upon which a hotel—the only asset of the corporation undergoing reorganization — had been constructed.

STATEMENT

The proceeding for the reorganization of Landmark Inns of Durham, Inc. ("debtor") under Chapter X of the Bankruptcy Act, 11 U.S.C. 501 *et seq.*, was commenced on September 3, 1969, by the filing of an involuntary petition against the debtor. The debtor consented to the petition shortly thereafter, and on September 12, 1969, the petition was approved and the respondent was appointed trustee (Pet. App. 16a, 34a).

The debtor's only asset of consequence is an eight-story motor hotel which it owns and operates (Pet. App. 5a, 18a, 29a). Opened for business in the summer of 1966 (Pet. App. 6a), the hotel was built and equipped by the debtor at a cost of about $1,500,000 (Pet. App. 6a, 19a). Of this, about $700,000 was supplied by public investors who purchased stock and debentures of the debtor (Pet. App. 4a, 20a).

The hotel was constructed on land leased to the debtor by petitioner in 1964 for a term of 52 years (Pet. App. 2a). The land had been acquired by the petitioners in 1942 for about $3,100 and is now worth about $150,000 (Pet. App. 1a, 19a, 35a). Petitioners have made no financial investment in the hotel.

The lease provided for termination upon "any act of the Tenant, the result of which would be to pass by operation of law, or otherwise, any interest or estate in the leased premises to any Trustee or Receiver in bankruptcy * * *" (Pet. App. 2a-3a, 36a). Contending that the filing of the involuntary Chapter X petition by three creditors (who were also major stockholders and active in the affairs of the debtor) (Pet. App. 16a, 36a) was an "act of the tenant" within the meaning of the lease, and asserting other alleged defaults under the lease,[2] petitioners asked the district court to declare the lease

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[2] Petitioners apparently now concede that the district court properly refused to grant a forfeiture based upon breaches of the lease other than the "breach pertaining to the institution of the Chapter X proceedings" (Pet. 6).

forfeited and to give them possession of the land and the hotel (Pet. App. 1a, 36a).

The referee in bankruptcy, to whom the proceeding was transferred by the district court (Pet. App. 21a-22a), found that all of the defaults under the lease had been cured (Pet. App. 20a, 30a) and that petitioners had been paid their rental to date (Pet. App. 30a). The referee also found that the petitioners had not been harmed by the breaches (Pet. App. 21a, 30a), that they would make more money under the operation of the hotel by the trustee than they had anticipated originally under the lease[3] (Pet. App. 30a), and that petitioners were satisfied with the trustee's management and the amount of the rental they were receiving (Pet. App. 19a). The referee further found that the fair market value of the hotel on a going concern as well as on a replacement cost basis was about $2,000,000 (Pet. App. 6a, 17a, 19a) and that the secured debt aggregated about $1,000,000 (Pet. App. 18a), so that to have permitted a forfeiture of the hotel built and equipped by the debtor, with 46 years remaining on the lease, would have constituted a windfall to the petitioners of "over $1,000,000 at the expense of the creditors, stockholders, and debenture holders" of the debtor (Pet. App. 30a-31a). The referee found that such a windfall "* * * would be grossly inequitable, unconscion-

[3] The lease is a "percentage lease" and the rental is based in part on the gross receipts (Pet. App. 2a, 35a), which had increased during the operation by the trustee (Pet. App. 15a, 17a).

able, unjust, and shock the conscience of this Court" (Pet. App. 31a).

The referee found, moreover, that if the lease were forfeited, the reorganization proceeding would be aborted since the only assets of the debtor were the hotel and the equipment and furnishings located therein (Pet. App. 18a, 29a); as a result, the creditors and stockholders would lose their entire claims totaling $878,530 (Pet. App. 21a), notwithstanding that the operation of the hotel by the trustee had been quite successful (Pet. App. 17a, 20a, 30a).

On review, the district court affirmed the findings of fact and conclusions of law of the referee and the denial of the forfeiture (Pet. App. 32a, 33a) and the court of appeals affirmed (Pet. App. 34a, 37a). In its order denying the petition for rehearing (Pet. App. 46a), the court of appeals noted that it had refused forfeiture of the lease because petitioners' insistence upon the forfeiture was, under the circumstances, highly unconscionable and inequitable—"a demand for blood"—and because a forfeiture would have defeated the reorganization aims of Chapter X. The court of appeals concluded "that as a court of equity the bankruptcy court had the discretion and power to refuse enforcement of * * * [the forfeiture clause in the lease] and rightfully exercised this prerogative" (*ibid.*).

ARGUMENT

The decision of the court of appeals, which rests on the rationale of this Court's decision in *Smith* v. *Hoboken R. Co.*, 328 U.S. 123, and follows the decision of the Third Circuit in *In re Fleetwood Motel*

Corporation, 335 F. 2d 857, is correct and presents no issue warranting review by this Court. Contrary to petitioners' assertions (Pet. 9), the decisions in the instant and *Fleetwood* cases are not in conflict with the decisions of this Court or any other court.

1. The portion of Section 70(b) of the Bankruptcy Act, 11 U.S.C. 110(b), which provides that "an express covenant that * * * the bankruptcy of a specified party [to a lease] * * * shall terminate the lease or give the other party an election to terminate the same is enforceable," was held by this Court in *Finn* v. *Meighan*, 325 U.S. 300, to be applicable to a reorganization proceeding under Chapter X of the Act since the forfeiture of a lease is not inherently inconsistent with the reorganization of a going business.[4] Less than a year after the *Finn* decision, the Court held in *Smith* v. *Hoboken R. Co.*, *supra*, that while the forfeiture provision of Section 70(b) is applicable to reorganization proceedings, whether a forfeiture provision should be enforced turns on the circumstances of the particular case. In *Smith*, a railroad reorganization proceeding under Section 77 of the Bankruptcy Act, the forfeiture clause was contained in a lease covering the major part of the assets of the debtor (328 U.S. at 124). This Court held that, under the circumstances, enforcement of

[4] Section 102 of Chapter X, 11 U.S.C. 502, provides that the provisions of the Bankruptcy Act relating to ordinary liquidating bankruptcy (which includes Section 70) are applicable to proceedings under Chapter X "insofar as they are not inconsistent or in conflict with the provisions" of that Chapter.

the forfeiture clause would be inappropriate since, among other reasons (328 U.S. at 132): "If forfeiture of the lease is now declared, no plan of reorganization may be possible." [5]

In *Fleetwood, supra*—a case strikingly similar to the instant case—the court of appeals relied on the rationale of *Smith* and the inherent equity powers of a bankruptcy court (335 F. 2d 862) and held that Section 70(b) did not require enforcement of a forfeiture clause in a lease where forfeiture would be inconsistent with the objectives of Chapter X.[6]

The arrangement here was essentially a security arrangement, designed to protect the lessor, and should be available to the lessor to protect him against loss. But courts of equity traditionally have refused to forfeit property interests to creditors for minor

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[5] While it is true that in *Smith*, as petitioners point out (Pet. 8), the forfeiture provision of the lease did not reflect the provisions of the Interstate Commerce Act requiring permission from the Interstate Commerce Commission for abandonment of railroad properties, the Court also noted that "[w]hether a particular carrier should go out of business presents problems of primary importance to its security holders * * *" (328 U.S. at 131-132). This statement is equally applicable to Chapter X proceedings.

[6] In *Fleetwood* the debtor, like the debtor here, built a motel on land it had leased from others with funds obtained from the sale of securities to the public. The court there denied the landlords' attempt to obtain possession, by invoking a forfeiture clause, on the grounds that it (1) would provide an unconscionable windfall to the landlords at the expense of public investors, who had invested over a half million dollars in the debtor, and (2) would abort the reorganization proceeding since the motel was the debtor's only asset.

breaches of financial arrangements that did not jeopardize the security, and particularly where forfeiture would give the creditor an unjustified windfall. For example, many mortgages on real property took the form of absolute conveyances of the land; the courts have not permitted the mortgagee to obtain the property as the result of a minor default by the mortgagor, such as a short delay in making regular payment, which did not prejudice the mortgagee. The defaults in the performance of the lease in this case have now been cured, and the operation of the motel by the trustee is more profitable to the lessor than its operation by the debtor. In these circumstances, the bankruptcy court, as a court of equity, properly refused to forfeit the lease—a forfeiture that would produce an unjustified windfall to the petitioners and was unnecessary to protect their security. Cf. *In re Pittsburgh Rys. Co.*, 155 F. 2d 477 (C.A. 3), certiorari denied, 329 U.S. 731.

2. Contrary to petitioners' assertions, there is no conflict among the circuits between the cases cited on pages 10 to 13 of the petition and the decision below or *Fleetwood*. Several of the cited cases involve liquidations in ordinary bankruptcy proceedings. Unlike ordinary bankruptcy, Chapter X seeks to conserve going-concern values and to foster reorganization. "The purpose of reorganization is to save a sick business, not to bury it and divide up its belongings" (*Susquehanna Chemical Corp.* v. *Producers Bank & Trust Co.*, 174 F. 2d 783, 787 (C.A. 3)). Hence, while enforcement of a forfeiture clause might thwart

that policy in a given reorganization proceeding, it could not do so in a bankruptcy liquidation. With one exception, the cases relied on which involve proceedings under Chapter X or Chapter XI of the Bankruptcy Act do not present equitable considerations of the type involved in the instant case or in *Fleetwood;* there is no indication, for example, that reorganization would be frustrated by a forfeiture, that the debtor had made any substantial investment on the leased premises or that the landlord would receive a windfall. In the one case where there were somewhat comparable equities to those here, *Friendly Center, Inc.* v. *Robinson*, 233 F. Supp. 274 (W.D. N.C.), the court, like the courts below, denied the landlord's request for forfeiture of a lease.

Petitioners recognize that if a forfeiture is not allowed in this case, "the [debtor] would most likely be in a position to reorganize with honest management, * * *" but they insist that they are entitled to a forefeiture "whether the demand is for blood or otherwise" (Pet. 10). We submit that the court of appeals correctly ruled that the bankruptcy court had discretion to refuse to order forfeiture.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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